Is real estate the next bubble?

Eric Simpson, CFA®, Senior Analyst, Fixed Income Credit

Among the many *lessons learned from the Great Financial Crisis of 2007–2009 is the crucial role U.S. property markets play in the broader economy. The subprime mortgage crisis and subsequent crash in home prices caused financial and economic pain not seen since the Great Depression.*

Ironically, it occurred four years after the Federal Reserve (Fed) began trying to prevent it, embarking on a series of interest rate hikes designed to deflate the housing bubble without popping it.

Today, the economy faces mounting concern that domestic property markets may again jeopardize an attempt by the Fed to induce a so-called "soft landing"—this time, referring to its effort to reduce widespread inflation without sparking a recession. Evolving work trends, inflationary pressures and the Fed's pivot from a highly accommodative monetary policy to its current restrictive stance all contributed to a challenging real estate investment climate in 2022.

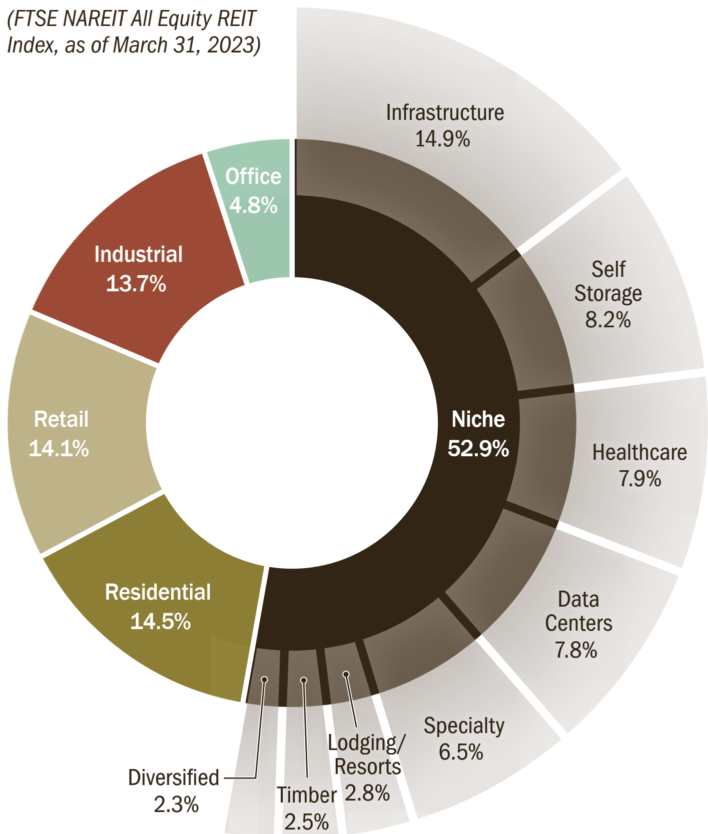
Real estate investments declined 24% for the year as measured by the FTSE NAREIT All Equity REIT Index, which contains nearly all tax-qualified real estate investment trusts (REITs) traded on U.S. exchanges. While all types of commercial real estate REITs within the index detracted from the index's performance in 2022, a considerable disparity existed in the underperformance among those categories. Areas such as retail and lodging REITs benefited from stronger-than-expected consumer spending. However, no category in the index detracted more from performance than office space, which returned 7% for the year ending December 31, 2022.[1]

> **U.S. regional banks account for about 70% of all commercial lending.**

Now, the 2023 outlook for real estate investments is growing more concerning for landlords and investors alike. The recent disruption to the global banking industry will likely diminish the availability of credit for commercial and industrial (C&I) loans. Regional banks account for nearly 70% of all C&I lending in the U.S. The likelihood of tighter liquidity requirements at these banks is coming at a time when many within commercial real estate are looking for flexibility.

COMPOSITION OF THE U.S. COMMERCIAL REAL ESTATE SECTOR

(FTSE NAREIT All Equity REIT Index, as of March 31, 2023)



Source: NAREIT, Commerce Trust. The FTSE NAREIT All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs It is not possible to invest directly in an index.

Social, Economic Drags on Office Space

For years, companies offered remote work options to employees as a recruitment and retention tool in support of talent management efforts. However, everything changed with the COVID-19 pandemic when work from home arrangements shifted from a company perk to an "adapt or die" operational necessity. Office buildings sat vacant throughout 2020 and into 2021, yet property owners were mollified by rent income and a low-interest rate environment favorable to debt financing.

Things certainly have changed. Pockets of the work force are reluctant to return to the office full time. U.S. office occupancy rates currently range between 40–60% of pre-pandemic levels. By comparison, global return-to-office rates are much higher, according to JLL, a property services firm that manages more than 4.5 billion square feet of real estate around the world. Office occupancy rates in Asia average 80–110% — meaning it's likely more people are working in offices across parts of Asia today than there were before the pandemic.[2]

Meanwhile, property owners have endured increased expenses. Strained supply chains, soaring inflation and higher borrowing costs all have boosted the costs of building materials. Moreover, the Fed has raised its benchmark rate by more than 450 basis points in less than a year and doesn't appear ready to quit.

> **About $150 billion in office mortgages will mature over the next two years.**

These considerable headwinds have conspired to produce a dire reality for office owners: More than 17% of the entire U.S. office supply currently is vacant with an additional 4% available for sublease. In addition, nearly $150 billion in office mortgages are set to mature during the next two years, according to the Mortgage Bankers Association.[3] Most of that debt will need to get refinanced at higher rates with more stringent capital requirements from lenders. This scenario may weed out overleveraged building owners, which could also exacerbate some of the negative occupancy trends and declining rents.

The recent default on $1.7 billion of debt by office-building owner Columbia Property Trust, purchased by Pacific Management Investment Management Co. in September 2021, highlights the scope of the office market's doldrums. So does the $69 billion Blackstone Real Estate Investment Trust, the largest U.S. fund specializing in commercial real estate investment. It halted redemptions amid a flood of withdrawal requests late last year and again reached its redemption limit in January.

Residential Property also Challenged

Ill-conceived subprime mortgage loans and the packaged debt securities containing them constituted the root of the financial dilemma during 2007–09. Low interest rates helped the housing market rebound after the financial crisis and then again following the initial onset of the pandemic. The parallels have raised concern that current housing prices once more could fall as fast they surged.

Sales of existing homes, which account for most of all U.S. single-family home transactions, fell nearly 18% in 2022. Prices also dropped as 2022 progressed: After reaching $413,800 in June, the median existing home price fell six straight months to end the year at $366,900, according to the National Association of Realtors.[4]

Apartment rents have fallen along with home prices, declining in all 52 metropolitan markets tracked by Apartment List for the six months through January. Median rents fell each month during that period — the first time that has happened in five years — dropping 3.5% overall. This trend is expected to continue despite the largest supply of new apartments in nearly four decades becoming available this year.[5]

Areas of Opportunity

Other areas of the real estate market offer brighter prospects. Per-room revenue in the global hotel and hospitality industry has recovered to 93% of pre-pandemic occupancy levels. China's recent reopening after finally lifting pandemic restrictions should further aid the occupancy rate recovery.[6] In addition, return-to-office trends in Europe and Asia bode well for global office occupancy rates despite the reticence of U.S. workers to completely give up working from home.

Consumer spending remains upbeat, which should provide support to retail leases. Meanwhile, industrial properties like warehouses and distribution centers may be somewhat insulated from the credit pressures facing other commercial real estate areas. Demand for warehouse space remains tight, keeping leasing prices elevated. Some developers are hopeful higher rental rates could offset increased financing costs.[7]

Bottom Line

Without question, real estate investments struggled in a rising global interest rate environment in 2022 and will encounter difficulty again this year.

A glut in office space persists, driven substantially by secular job market changes, pressuring giant real estate investment funds and reflected in high-profile. A similar glut in multi-family housing potentially looms, and home sales and prices continue falling steadily.

However, strengths in areas of the commercial market — hotels, retail and warehouses — and relatively healthy U.S. consumer data all should help an albeit gloomy property market avoid a Great Recession-style meltdown.

1 FTSE NAREIT All Equity REITs Index, Commerce Trust. The FTSE NAREIT All Equity REITs Index is a free-float adjusted, market capitalization-weighted index of U.S. equity REITs

2 As Americans Work from Home, Europeans and Asians Head Back to the Office, The Wall Street Journal, Feb. 28, 2023

3 Two Office Landlords Defaulting May Just Be the Beginning, Bloomberg, March 1, 2023

4 U.S. Existing-Home Sales Slid Last Year as Interest Rates Surged, The Wall Street Journal, Jan. 20, 2023

5 Apartment Rents Fall as Crush of New Supply Hits the Market, The Wall Street Journal, Feb. 27, 2023

6 Global Real Estate Perspective – Highlights, JLL, March 2023

7 Warehouses Find Insulation from U.S. Banking Crisis, The Wall Street Journal, March 30, 2023.

Eric Simpson, CFA®

Senior Analyst, Fixed Income Credit

Eric is an investment analyst for Commerce Trust Company. His primary focus is within the corporate fixed income market where he uses fundamental and technical analysis to recommend securities for client's portfolios. He has a deep understanding of fixed income markets and fixed income portfolio construction, which allows him to serve clients needs and help achieve their objectives. He joined Commerce in 2015 as a manager research analyst and has held several different analyst positions that have helped foster a solid analytical foundation and give him a unique skill set to help clients understand the changing dynamics of the investment universe. Eric graduated from Saint Louis University in 2012 with a Bachelor of Science in Economics. He is a CFA Charterholder and a member of the St. Louis CFA Society.

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